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Illinois Bell Telephone Company Application for Review of Alternative Regulation Plan	))))	Docket No. 98-0252
Illinois Bell Telephone Company Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates	)))))	Docket No. 98-0335
Citizens Utility Board, People of the State of Illinois v. Illinois Bell Telephone Company	)))))	Docket No. 00-0764 (Consol.)

REPLY BRIEF OF AMERITECH ILLINOIS

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TABLE OF CONTENTS

STATE OF ILLINOIS
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Illinois Bell Telephone Company Application for Review of Alternative Regulation Plan	))))	Docket No. 98-0252
Illinois Bell Telephone Company Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates	)))))	Docket No. 98-0335
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REPLY BRIEF OF AMERITECH ILLINOIS

Illinois Bell Telephone Company ("Ameritech Illinois" or "the Company"), by its attorneys, hereby files its Reply Brief in response to the Initial Briefs submitted by the Staff of the Illinois Commerce Commission ("Staff"); the Citizens Utility Board ("CUB"); the People of the State of Illinois ("Attorney General"); Cook County State's Attorney's Office ("Cook County"); the City of Chicago ("City of Chicago") (collectively "GCI"); United States Department of Defense and All Other Federal Executive Agencies ("DOD"); AT&T Communications of Illinois, Inc. ("AT&T"); and McLeodUSA Telecommunications Services, Inc. ("McLeod").

I. SUMMARY OF POSITION

The Alternative Regulation Plan adopted by the Commission in 1994 was and still is a forward-looking response to the changes taking place in the telecommunications industry. Although this Commission was one of the first to adopt a pure price regulation plan (i.e., a plan without earnings sharing), the FCC and other state regulators have since followed suit. Price regulation is the rule, not the exception, in the industry today. This consensus has developed precisely because price regulation is the most effective regulatory response to changing marketplace conditions: it provides the regulated company with market-like incentives to improve its operations and, over the long run, it protects consumers from the business and financial risks associated with competition and technological change. All of these considerations are more compelling today than they were in 1994.

Staff's proposals in this case have been, for the most part, forward-looking and consistent with the policy objectives the Commission established for the Plan. Staff proposes that the Plan be extended, subject to certain terms and conditions. Staff's proposed terms and conditions would, for the most part, leave the fundamental structure of the Plan intact. Although the Company does not agree with all of Staff's proposals, they are a principled response to the issues raised in this proceeding.

Staff's principal concern is that the service quality component of the Plan be modified and expanded to ensure that consumers receive the high quality service to which they are entitled. Ameritech Illinois is also committed to ensuring that the service problems of last year do not recur. These problems were not the result of any intentional actions by the Company. Extraordinary efforts have since been and continue to be directed at solving them and ensuring that the expectations of both consumers and this Commission are met. Recognizing the importance of this issue, the Company has attempted to reduce its differences with Staff over the components of a revised service quality plan. Although Staff and the Company are not in complete agreement on what would constitute appropriate customer credits in the event that established service standards are missed, there is now little dispute over the relevant service measures and benchmarks (or standards of service) which must be satisfied.

GCI, on the other hand, still remains wedded to outmoded and dysfunctional regulatory models. These parties want to roll back the clock and subject Ameritech Illinois to the kind of rate of return analysis which the Commission rejected seven years ago, while at the same time keeping all the benefits of price regulation (e.g., annual rate reductions under the price index). Such a one-sided, opportunistic approach to regulation should not be adopted.

GCI's other specific objections to the Plan's performance involve service quality and competitive classifications. As Staff recognizes, service quality problems can be addressed within the context of the Plan, without having to make radical modifications. Both Staff and GCI believe the Company's past approach to service reclassifications under Section 13-502(b) has been overly aggressive. However, this is not a defect in the Plan, which applies only to noncompetitive services. If the Commission believes that services have been reclassified prematurely, appropriate mechanisms exist today to reverse the classifications and refund any rate changes implemented while the service had been reclassified.

Most of the issues raised by Staff and the other parties were addressed in Ameritech Illinois' Initial Brief. To avoid repetition, and in light of the page limitations imposed on the parties, the Company will avoid restating positions and arguments to the maximum extent possible. Thus, failure to respond to every argument raised by Staff or the other parties in this reply brief should not be construed as agreement.

II. THE ALTERNATIVE REGULATION PLAN PERFORMED WELL OVER ITS INITIAL FIVE-YEAR TERM

A. THE PLAN MET THE COMMISSION'S GOALS SET FORTH IN THE 1994 ORDER

As Ameritech Illinois demonstrated in its Initial Brief, the Commission established four primary goals for the Company's Plan and all of them were met over its initial term. (Am. Ill. Init. Br., pp. 15-17). Consistent with their positions throughout the proceeding, GCI largely ignores these goals and focuses instead on earnings, competitive service reclassifications and service quality. It is important, however, to address what the Commission intended to accomplish. For example, the Commission was deeply concerned about the capital recovery dilemma which it faced as a regulator and to which price regulation was a critical response. 1994 Order at pp. 54-56. GCI's refusal to even acknowledge this issue, much less address it substantively, borders on the disingenuous.

Staff claims that Ameritech Illinois has overstated the rate benefits which accrued to noncompetitive customers over the term of the Plan, because it ignored the demand effects from rate changes for relatively elastic services. (Staff Init. Brief, pp. 23-24). Staff's continued insistence on this point is baffling. As Ameritech Illinois explained at length in testimony, Staff is confusing the revenue impact on Ameritech Illinois with the benefits to consumers from any given set of rate changes -- they are not the same. When a price change stimulates demand, the increase in "consumer surplus" is larger than the effect of the rate reduction alone, not smaller. (Am. Ill. Ex. 1.4, pp. 8-11). This is a basic concept taught in most introductory economics courses and has never been refuted by Staff or any other party.

CUB contends that rate reductions for "basic services" have proved "elusive" and that residential noncompetitive service customers have experienced rate increases. (CUB Init. Br, pp. 10-11). CUB is incorrect. It is undisputed in the record that Ameritech Illinois has implemented all of the rate reductions required by the Plan. The SimpliFive and CallPak plans to which CUB refers did not "raise" Bands A and B usage rates. They offered customers new packages of usage services which were optional. Furthermore, although the calling plan rates for Bands A and B usage were higher than standard rates, the lower rates for Band C usage saved customers many millions of dollars over standard tariff rates. (Am. Ill. Ex. 1.3, p. 93; Am. Ill. Ex. 1.3, p. 93). This is also undisputed in the record.

CUB's arguments relative to earnings, competitive classifications and service quality will be addressed in more detail infra. However, it is patently untrue that the benefits of the Plan have flowed "only" to Ameritech Illinois shareholders. (CUB Init. Br., p. 14). Ratepayers received significant benefits under the Plan which they would not have received under rate of return regulation, in the form of annual price decreases. These decreases were substantial in amount. CUB is also ignoring the fact that the Plan will provide both short-term and long-term benefits, and the long-term benefits will likely prove to be the most significant.

B. THE STATUTORY CRITERIA SET FORTH IN SECTION 13-506.1 OF THE ACT WERE MET

1. Fair, Just and Reasonable Rates

Staff agrees that Ameritech Illinois' noncompetitive rates today are just and reasonable. As Staff states, this analysis is quite simple:

> "If rates were set at a just, reasonable and affordable level in 1994, and thereafter declined, notwithstanding modest levels of inflation, it stands to reason that such rates are now a fortiori just, reasonable and affordable." (Staff Init. Br, p. 30, emphasis in original).

Staff's analysis is consistent with the approach which Ameritech Illinois has been advocating since the outset of this proceeding. (Am. Ill. Ex. 1.1, p. 70).

The ongoing debate between Ameritech Illinois and GCI over what constitutes "fair, just and reasonable rates" under the Plan has not advanced substantively. GCI continues to claim that this standard must equate to what would result from a traditional rate case. (CUB Init. Br., pp. 27-29; AG Init. Br., pp. 24-25; Cook County Init. Br., pp. 28-29; City Init. Br., p. 32). As the Company demonstrated in its Initial Brief, this position is inconsistent with the economic and policy underpinnings of price regulation, it is not supported by the Commission's 1994 Order and it results in a nonsensical interpretation of Section 13-506.1. (Am. Ill. Init. Br., pp. 20-22).

GCI's citations to the Commission's 1994 Order do not provide any support for its position. (CUB Init. Br., pp. 31-32; AG Init. Br., p. 25; City Init. Br., pp. 38-39). The fact that the Commission reiterated its commitment to "marginal cost-based prices" is only relevant to service cost/rate design issues, not revenue requirements analysis. The fact that the Commission required the Company to report earnings data to provide an "early warning" that the index was misspecified says nothing about reinitializing rates -- particularly where, as here, the index worked properly. Finally, the fact that the Commission indicated a willingness to reconsider earnings sharing also says nothing about reinitializing rates; even earnings sharing plans assume that earnings will exceed what would result from a conventional rate case.[1]

GCI contends that the Company's earnings demonstrate that the Plan was, in fact, "misspecified". (AG Init. Br., pp. 25-26; City Init. Br., pp. 35-36). There is absolutely no basis in the record for this assertion. Dr. Meitzen's analysis showed that the X factor was, if anything, too high over this period. This means that noncompetitive service customers received more

[1] The Attorney General claims that the Commission established rate of return regulation as a "touchstone" in the 1994 proceeding, because it compared anticipated Plan rates to rates under rate of return regulation. (AG Init. Br., p. 24). The Commission's statement was made in the context of assessing alternative values for the X factor, with which it had had no prior experience. It does not address how the term "fair, just and reasonable" would be interpreted in this proceeding, once price regulation was in place.

benefits than they were entitled to, not fewer. (Am. Ill. Ex. 1.1, pp. 29-30).

The City of Chicago claims that the Company's earnings cannot be explained by improved productivity. (City Init. Br., p. 36). The record proves this statement wrong. Ameritech Illinois' total factor productivity growth rate increased from 2.2% over the 1984-91 period to 4.2% over the 1992-99 time period. (Am. Ill. Ex. 2.1, p. 7; Am. Ill. Ex. 2.2, p. 5). Thus, it almost doubled. Furthermore, this data represents growth in TFP; that is, even if it had remained at the 2.2% level, the Company would still be increasing its productivity year-over-year by 2.2%. The fact that the 3.3% overall X factor did not change -- which the City of Chicago relies on for its statement -- is a function of the fact that the Commission overstated the Company's future input price performance in 1994 and the parties' unanimous proposal to shift to an industry-wide TFP figure. It does not represent stagnant productivity performance.

CUB and the Attorney General contend that Ameritech Illinois would not have achieved these earnings in a competitive industry. (CUB Init. Br., pp. 79-80; AG Init. Br., p. 26). This is patently untrue. As Dr. Avera explained, this was a period of record economic growth and record corporate profits. (Am. Ill. Ex. 8.0, pp. 8-10). Companies in fully competitive industries reported earnings of which (to use CUB's words) Ameritech Illinois "can only dream"; for example, in 1999, Quaker Oats, General Mills and Campbell Soup outstripped Ameritech Illinois' return on equity by over 13 thousand, 20 thousand and 25 thousand basis points, respectively. (Am. Ill. Ex. 1.4, p. 28). It is a fiction that the "reasonable return" produced by conventional rate case analysis bears any necessary relationship to what actually transpires in competitive markets. It is a necessary fiction in the world of rate of return regulation, but it should not be confused with reality.[2]

Both CUB and the Attorney General rely on Ms. TerKeurst's comparison between the earnings of the major BOCs over the 1990-99 period, based on ARMIS reports to the FCC, to argue that Ameritech Illinois' profitability greatly exceeded that of its peers. (CUB Init. Br., p. 30; AG Init. Br., pp. 11-12). This comparison made no sense on its face and it cannot be relied on for any purposes. (Tr. 2169-73). As demonstrated in testimony and in the cross-examination of Ms. TerKeurst, Ameritech Illinois treated certain industry-wide accounting changes (i.e., FAS 106, FAS 112 and FAS 71) differently for ARMIS reporting purposes than the rest of the industry. (Am. Ill. Ex. 1.4, pp. 27-28; Tr. 2171-72; 1994 Order at pp. 114-15). As a result of this anomalous accounting treatment, Ameritech Illinois' total stockholder equity had dropped by 50% by 1994-95, which, in turn, artificially inflated its "earnings" relative to the other BOCs. (Am. Ill. TerKeurst Cross Ex. 46). As Ms. TerKeurst agreed, no meaningful comparison can be made between companies' earnings unless the underlying data is stated on a consistent basis and that certainly was not the case here. (Tr. 2174-75).

CUB claims the Company's alternative showing that noncompetitive rates are more "affordable" today than they were in 1994 is irrelevant because residential customers cannot "shop around" for other providers. (CUB Init. Br., p. 30). This argument is a non sequitur. The Company's affordability analysis evaluated its prices in light of the CPI and increases in consumer buying power over the first term of the Plan. (Am. Ill. Ex. 1.1, pp. 13-14, 72-73).

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[2] The Attorney General also misuses Dr. Avera's testimony on the issue of the sustainability of "high" profit levels. First, what investors perceive as a "high" return may be quite different from what results from rate cases. Second, investors take a long run view of earnings. The "temporary competitive advantage" or "temporary economic advantage" Dr. Avera referred to can last for years, until competitors adapt or the economy downshifts. Ameritech Illinois' economic performance over the first term of the Plan is no more guaranteed to continue than that of any other company. In fact, Dr. Avera explained in detail that Ameritech Illinois' earnings are more sensitive to economic conditions than many companies', because of the capital intensive nature of its business. (Am. Ill. Ex. 8.0, pp. 20-22). What goes up also comes down and may well come down with a jolt.

This comparison has nothing whatsoever to do with the existence of competitive alternatives; it would be equally relevant in a pure monopoly environment.

GCI argues that that Commission is obligated to ensure that competitive service rates are "just and reasonable". (AG Init. Br., pp. 27-28; City Init. Br., pp. 33-34; CUB Init. Br., pp. 39-40). The reasonableness of Ameritech Illinois' competitive service rates is beyond the scope of this proceeding, which is directed at the performance of the Plan over its initial term. The Plan, both by its terms and by statute, is limited to noncompetitive services. (Am. Ill. Init. Br., pp. 20-22). GCI's statutory citations are unavailing. The fact that Section 13-506.1(b)(4) incorporates Section 13-103(a) does not expand the scope of this section -- all of Section 13-506.1 follows prefatory language which authorizes the Commission to implement "alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services...." (emphasis added).

Ameritech Illinois does not dispute the fact that other provisions of the Public Utilities Act provide the Commission with "just and reasonable" authority over competitive service rates (i.e., Sections 9-250 and 13-505(b)). However, nothing in the Commission's 1994 Order remotely suggested that competitive service rates were to be the subject of this proceeding. To the extent that GCI believes that Ameritech Illinois prematurely classified services as competitive -- and they clearly do -- that issue is appropriately the subject of investigatory proceedings like Docket 98-0860. Moreover, GCI's blanket assertion that many of the services which Ameritech Illinois has classified as competitive over the last few years "failed to withstand the test" in contested proceedings misstates the Company's record. (CUB Init. Br., pp.

12, 24; AG Init. Br., pp. 18-19; Am. Ill. Ex. 1.4, pp. 42-43).[3]

For services properly classified as competitive, the issue of "just and reasonable" rates is far more complex than the earnings review on which GCI is relying. Any regulatory restrictions on competitive service pricing should apply even-handedly to all providers of that service. (Am. Ill. Ex. 1.3, p. 33). This has been the Commission's practice to date. (Am. Ill. Ex. 1.4, p. 41). IXCs and CLECs have routinely been exempted from rate of return regulation in their certificate application proceedings. For example, in the 1987 certificate order for TRI-J Communications, the Commission stated as follows:

> "Applicant is a non-dominant telecommunications carrier and, as such, asks that it be exempted from 83 Ill. Adm. Code 250.10, 710 and 735. Concerning Part 710 (Uniform System of Accounts), the Commission notes that the Act indicates that rate base rate of return regulation is suitable only for those telecommunications carriers offering noncompetitive service. Both Part 710 and 735 (Credit, Billing, Deposits and Termination of Service) have been waived for many other telecommunications carriers including Allan. Similar waivers are also appropriate for TRI-J." Order in Docket 86-0373, adopted February 4, 1987, 1987 Ill. PUC LEXIS 34.

See also Order in Docket 93-0409 (MFS Intelenet of Illinois, Inc., adopted July 20, 1994, 1994 Ill. PUC LEXIS 288; Order in Docket 95-0269 (LCI International Telecom Corp.), adopted January 10, 1996, 1996 Ill. PUC LEXIS 12; Order in Docket 95-0429 (Cable and Wireless, Inc.), adopted February 22, 1996, 1996 Ill. PUC LEXIS 84. Therefore, before embarking on any analysis of Ameritech Illinois' competitive service rates, the parties would have to address what standard other than earnings would be used to determine "just and reasonable" rates. Moreover, to establish industry-wide pricing rules, IXCs and CLECs would have to be provided notice and

[3] Staff suggests that rate increases for services which have been improperly classified as competitive are per se unjust and unreasonable. (Staff. Init. Br., pp. 30-31). The Company does not agree. Section 13-502(c) gives the Commission the option to require refunds and rate reductions, but does not require it. The Commission should consider all of the relevant factors before utilizing this authority.

an opportunity to participate. No such notice was provided in connection with this proceeding.

Finally, even if competitive service rates were at issue in this proceeding -- which they are not -- there is no evidence that they warrant a $1 billion rate decrease. As CUB acknowledges, only "some" of them have been the subject of rate increases. (CUB Init. Br., p. 34). Ameritech Illinois believes that these rate changes were appropriate in the marketplace. (Am. Ill. Ex. 1.3, p. 143; Am. Ill. Ex. 1.4, p. 6). With respect to the remaining services whose rates have not changed, there is absolutely no evidence that their rates are too high. The mere fact that Ameritech Illinois' competitive services generate higher earnings than noncompetitive services reflects long-established pricing policies and says nothing about their reasonableness: they are competitive largely <u>because</u> they are profitable and profit margins attract competitors. (Am. Ill. Ex. 1.2, pp. 7, 17-18; Am. Ill. Ex. 1.3, pp. 69-70). Given the poor returns generated by noncompetitive services (5.55%), Ameritech Illinois' financial viability has depended on and continues to depend on the fact that competitive services in aggregate earn substantially above its authorized return.

2. Changes in Technology and the Structure of the Telecommunication Industry

CUB and the Attorney General contend that the Plan did not respond to changes in the industry which were, in fact, occurring because the residential local service marketplace is not yet fully competitive. (CUB Init. Br., p. 35; AG Init. Br., pp. 30-31). They misperceive the Commission's expectations in 1994. The Commission adopted price regulation because it would adapt to marketplace changes over the long run -- not just those of the next five years. In fact, the Commission imposed a five-year rate cap on residential services because it assumed that residential local service would <u>not</u> become fully competitive and would <u>not</u> become subject to marketplace pricing constraints during this period: the Commission specifically stated that this rate cap would allow it to "grapple with the complex social and economic issues associated with new technologies and emerging competition" during this period. 1994 Order at p. 65 (emphasis added).

CUB and the Attorney General also claim that the Plan has not been responsive to changes in technology. (CUB Init. Br., pp. 35-36; AG Init. Br., pp. 33-35). They primarily complain that Ameritech Illinois has not adequately upgraded its network. The record demonstrates that Ameritech Illinois has, in fact, invested in the technology required to bring advanced services to this state. (Am. Ill. Init. Br., pp. 33-34). The Attorney General's claim that pair gain technology (digital loop carrier systems) disadvantages customers is incorrect: this technology has been widely used by local exchange companies since the 1980's and provides the most cost effective means of provisioning a high quality outside plant network. (Am. Ill. Ex. 5.1, pp. 2-4). The demand for high-speed Internet access is a relatively recent phenomenon and customers can obtain it from any one of many alternative providers.

More to the point, CUB and the Attorney General are ignoring the risks associated with technological change and the Commission's concern that ratepayers be protected from those risks. 1994 Order at pp. 187-88. It is clear in the record that technology is changing at a rapid rate and that, over the long run, the Plan will better protect customers from the financial consequences of that change than rate of return regulation. (Am. Ill. Init. Br., p. 26).

3. Efficiency Gains and Cost Savings

CUB and the Attorney General contend that ratepayers did not appropriately benefit from the efficiency gains and cost savings which resulted from the Plan. (CUB Init. Br., pp. 24, 37;

AG Init. Br., p. 37).[4] Their arguments, however, rest on a commingled view of noncompetitive and competitive service rate changes and earnings. This is improper. The Plan's performance has to be assessed in terms of the services to which it applied. It is undisputed in the record that the X factor flowed through to customers of Ameritech Illinois' noncompetitive services all of the productivity gains which the Company achieved. (Am. Ill. Init. Br., pp. 27, 40). CUB's contemptuous dismissal of the benefits associated with increased sales of vertical services ignores the fact that customers like and use these products -- if not, they would not buy them in the first place or would cancel them after a few months' experience.[5]

4. Service Quality

The Initial Briefs of Staff and the GCI do not vary substantially from their testimony on the issue whether the statutory goal of maintaining service quality has been met. Those positions were discussed in Ameritech Illinois' Initial Brief. (Am. Ill. Init. Br., pp. 28-29).

In their Briefs, Staff and GCI continue to focus primarily -- indeed almost exclusively-- on two service quality issues: performance for the measure Out of Service Over 24 Hours ("OOS>24") and the more generalized installation and repair problems during the second half of 2000. Ameritech Illinois does not dispute its failures regarding those issues, nor has it minimized the seriousness of those failures. However, the most important question before the Commission regarding service quality in this proceeding is whether the Plan on the whole

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4 CUB claims that the Company's X factor proposal is inconsistent with the "commonly known trend of large scale price decreases in the prices of most telecommunications equipment and facilities". (CUB Init. Br., p. 24). In fact, the impact of these price decreases has been fully taken into account in the input price differential analysis, which captures all trends in prices for inputs purchased by telecommunications carriers. (Am. Ill. Ex. 2.1, pp. 4, 8-9; 1994 Order at pp. 25, 36-37).

5 CUB claims that these increased sales were due to the SBC/Ameritech merger, not the Plan. (CUB Init. Br., p. 24). This is untrue. The financial analyses in this proceeding are based on 1999 data. Since the merger did not close until late September of 1999, vertical services sales during the term of the Plan cannot be attributed to SBC.

succeeded in maintaining service quality. When service quality performance is considered for all measures over the entire period of the Plan, it is clear that the Plan's successes outnumber its failures by a large margin. This is true even if one measures the success of the Plan in exactly the ways that Staff and the GCI allege that the Plan should be judged.

Staff witness McClerren testified that the success of the Plan should be measured, at least with respect to the measures in the current Plan, by comparing performance before and after the Plan was adopted. He compared the years 1995-2000 to the years 1990-91 and 1990-94, respectively. Mr. McClerren performed this analysis only for OOS>24. (Staff Ex. 22.0, pp. 5-6). However, the results for the other seven measures all show steady improvement over the initial term of the Plan. In fact, many of the most important measures of service quality improved by large margins. For example, Trouble Reports per 100 Access Lines, the best overall measure of network performance, improved by more than 30% from 1990-94 to 1995-2000. The other measures improved over that period by margins ranging from roughly 20% to 100%. Thus, based on Staff's approach, most measures of service quality have improved markedly. (Am. Ill. Ex. 12.1, pp. 6-8).

GCI witness TerKeurst testified that, to get a more complete picture, one must also consider measures of service quality other than those included in the Plan. She did not actually perform that analysis, claiming that no pre-Plan data were available for measures outside the Plan. (GCI Ex. 12.0, pp. 3-6). However, based on data submitted by CUB in its 1996 service quality complaint case, the comparison suggested by Ms. TerKeurst also shows that service quality has not declined, but instead has improved since the Plan was adopted. Data since the adoption of the Plan are either consistent with or better than pre-Plan data for all such measures for which data are available: Business Office Answering Time, Repair Office Answering Time, Repeat Trouble Rate (Installation), Repeat Trouble Rate (Repair), and Missed Repair Appointments. (Compare Am. Ill. Ex. 3.4, pp. 17-19 & Sch. 3.44 with GCI Ex. 2.1). Thus, service quality has also improved based on the approach suggested by Ms. TerKeurst.

Regarding OOS>24, Ameritech Illinois does not deny it has struggled to comply the Commission's five-percent standard. The Initial Briefs of Staff and GCI add little to the record. As Ameritech Illinois has explained, this is a very demanding benchmark. However, Ameritech Illinois recognizes its responsibility to comply with this measure and is committed to meeting it. That commitment is reflected in the sharp drop in OOS>24 cases, from an average of 14.1% in 1995-97 to an average of 7.9% in 1998-99--approximately the same level at which the Company was performing before the Plan was adopted. With the increases in network staffing and spending discussed below, Ameritech Illinois is on track to comply consistently with this benchmark, as its recent performance shows.[6] (GCI Ex. 2.2; Am. Ill. Ex. 12.0, pp. 3-7; Am. Ill. Ex. 12.1, pp. 2, 6-7, 34-35).

Regarding the installation and repair delays that occurred in the second half of 2000, Mr. Hudzik testified that the problems were the result of the retirement of an unexpectedly large number of network employees in 1999, coupled with rising workloads and inclement weather. (Am. Ill. Ex. 12.0, pp. 7-8).

Some of the parties have suggested that a lack of network facilities also contributed to the installation and repair problems in 2000. (See AG Init. Br., pp. 15-16). However, the record contains little, if any, evidence that the network itself is deficient. Performance for Trouble Reports per 100 Access Lines, the most important measure of network performance, has

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6 Mr. Hudzik testified that Ameritech Illinois OOS>24 performance for January 2001 was 4.3%. (Am. Ill. Ex. 12.1, p. 2). Ameritech Illinois has since met the OOS>24 standard for February and March, and performance for 2001, through March, is 3.98. The data are on file with the Commission. Administrative notice requested.

improved significantly under the Plan, from an average of 2.92 for 1990-94 to an average of 2.02 for 1995-2000. (Am. Ill. Ex. 12.1, p. 6). In 2000, only 1.81 access lines per 100 were out of service. (Id., pp. 11-12). Dial Tone Within Three Seconds and Trunk Groups Below Objective, which also measure network performance, have improved to a point that problems are virtually extinct, and Staff has proposed to eliminate both of those measures. (Staff Ex. 8.0, p. 11; Staff Ex. 9.0, p. 26). Furthermore, Ameritech Illinois' installation and repair performance have improved rapidly as hiring progressed. That improvement would not have been possible if adequate facilities were not available. (Am. Ill. Ex. 12.1, pp. 2-3, 11-12; Tr. 1979-80). All of this is strong evidence that headcount losses, not inadequate network facilities, led to the installation and repair delays that occurred in the second half of 2000. (Tr. 1979-80, 1987-88).[7]

Cook County appears to agree that headcount was the problem. However, Cook County alleges that the loss of headcount was "the product of calculated decisions by Ameritech executives to cut costs post-merger." According to Cook County, Ameritech Illinois "offered early retirement packages and other incentives to retire to some of its most experienced managers and technicians prior to the 'unanticipated' exodus that led to the service problems in the second half of 2000." (Cook County Init. Br., pp. 57-60). Cook County's allegations are absolutely wrong. In fact, Ameritech Illinois offered no enhanced retirement benefits to either management or non-management network employees before the headcount losses occurred. Cook County's allegations to the contrary have no basis in the record.

7 Mr. Whitacre's comments, quoted by the GCI, are not to the contrary. As Mr. Hudzik explained: "[T]o the extent that additional infrastructure investments could have offset the impact caused by the loss of much of our workforce, it might have mitigated some of the service problems experienced in 2000. However, the more immediate problem was the effect of construction forces that typically are devoted to infrastructure improvements and expansion to address the daily repair and installation loads, which were building due to loss of many of our technicians. I see nothing in Mr. Whitacre's statements that would be to the contrary. In fact, Mr. Whitacre specifically noted that the problem was being addressed by hiring additional technicians." (Am. Ill. Ex. 12.1, p. 12).

As Mr. Hudzik explained, an unexpectedly high number of network employees retired in 1999. (Tr. 1848-49; Cook County Init. Br., Attach. A, pp. 30-35). This occurred despite the fact that Ameritech Illinois' had proactively implemented measures which offset the impact of GATT-related changes for all network employees, both management and non-management, that would potentially be affected. (Tr. 1953-54; Cook County Init. Br., Attach. A, pp. 33-38). Far from being an incentive to retire, as Mr. Hudzik explained, "the purpose of it was to get employees to change their minds and not retire . . ." (Tr. 1953).

Citing cross-examination Exhibits 40 and 41, Cook County asserts that Ameritech Illinois "offered early retirement incentives, including Supplemental Income Protection Program (or SIPP) benefits, to network technicians who retired during that same period [i.e., 1999]." In the next sentence, Cook County again refers to SIPP as a "retirement benefit." (Cook County Br., p. 58). The exhibits simply do not support Cook County's argument. To the contrary, the exhibits make clear that SIPP was simply one of the normal benefits available to technicians under their collective bargaining agreement. SIPP was not unusual, nor was it an inducement to retire. (Tr. 1887-88). Exhibit 40 states, "All employees were treated under the terms of the respective collective bargaining agreements when applicable. The terms of such agreements could provide the employees referenced above to additional compensation, such as SIPP, when required." (Cook County Ex. 40 (emphasis added); see Tr. 1890). Similarly, Exhibit 41 provides, "To the extent required by its Collective Bargaining Agreement, the Company did offer appropriate packages, bonus payments and/or incentives to employees who left the Company during these time frames." (Cook County Ex. 41 (emphasis added); see Tr. 1892). And, when Mr. Heaton asked Mr. Hudzik if SIPP could be characterized as an incentive for an employee to leave the Company, Mr. Hudzik responded that he had never heard it described as such. (Tr. 1887-88).[8]

Cook County also asserts that Ameritech Illinois induced its network managers to retire early pursuant to the Enhanced Pension and Retirement ("EPR") program. (Cook County Init. Br., pp. 59-60). This argument is flawed in several respects. First, the EPR offer did not occur "prior to" the 1999 headcount losses, as Cook County claims. (See id., p. 57). Instead, it occurred "at the very end of the year 2000." (Tr. 1870). Indeed, that fact is recognized in CUB's Initial Brief (p. 44). By that time, Ameritech Illinois had been hiring aggressively for more than a year (since third quarter 1999), and both headcount and service quality performance had returned to prior levels. (Am. Ill. Ex. 12.0, pp. 8-9). Second, the EPR offer cannot be considered an "early retirement package" for network managers, as alleged by Cook County. (Cook County Init. Br., pp. 57, 59). The network organization strictly limited eligibility to those who were already eligible to retire. (Tr. 1871-72). Third, these management retirements did not translate into headcount losses. In fact, no network management positions were eliminated in 1998, 1999 or 2000. (Tr. 1882, 1886).

Ameritech Illinois acted early and aggressively to maintain its network headcount. As noted above, Ameritech Illinois renegotiated its collective bargaining agreements and offered additional benefits to non-management employees to avoid GATT-related headcount losses. Those changes were effective January 1, 1999. (Tr. 1848-49, 1952-54; Cook County Br., Attach. A, pp. 33-38). By mid-1999, when attrition proved greater than expected, Ameritech Illinois identified the problem and began hiring immediately. (Tr. 1954; Am. Ill. Ex. 12.0, p. 8). By

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8 Moreover, the impact of SIPP was negligible, even it Cook County had characterized it correctly. Of the 800 network employees who left the Company in 1999, only 25 received SIPP payments. (Cook County Br., Attach. A, p. 30).

January 2000, long before service quality problems began, headcount was rising. And in early 2000, still before service quality problems became apparent, Ameritech Illinois accelerated the hiring program. (Am. Ill. Ex. 12.0, pp. 8-9). By the beginning of 2001, Ameritech Illinois had added 1468 network employees (over 17%), far more than restoring the 10% headcount loss that had occurred in 1999. (Id., p. 9 & Sch. 12.1). Forecasts call for Ameritech Illinois to add another 900 network employees by the end of 2001. (Tr. 1958).

The headcount increases have been accompanied by an enormous increase in network spending. Network capital investments in Illinois have grown from $787 million in 1999, to $918 in 2000, to $1.043 million (estimated budget) for 2001. Expenses have risen from $495 million in 1999, to $664 million in 2000, to nearly $800 million (estimated budget excluding network planning and engineering) in 2001. (Am. Ill. Ex. 12.1, p. 13).

Performance has responded accordingly. Since the second half of 2000, the average interval for installations requiring field visits fell from 14 days to 5 days. Pending installation orders requiring field visits dropped from 48,506 to 22,411. In addition, OOS>24 was reduced to 4.3%, the average interval for all repairs fell from 54 hours to 21 hours, and the pending repair load shrunk from 19,501 cases to 9,323. (Am. Ill. Ex. 12.1, p. 2). At same time, customer complaints fell dramatically. (Id., p. 3).

Some of the GCI parties contend that business and repair office answering performance has also been deficient. However, there is little evidence to support this claim. Business and repair office answer times are new Part 730 standards in Illinois, having become effective in October 2000. As a result, answer time data are limited, and the data available prior to October do not consistently measure performance for the same calling centers. (See GCI Ex. 2.2). While the GCI parties have characterized answer times as excessive, there is no evidence that actual consumers share that view. In fact, Staff's review of customer complaints did not identify answer times as a problem. (Staff Ex. 8.0, pp. 9-13). Similarly, customer survey data for February through August 2000 showed that customers rated the ease of getting their calls through to Ameritech Illinois' business and repair offices in the neutral to satisfied range--from 64.6 to 75.3, where 54 is neutral and 84 is satisfied. (Staff Ex. 8.0, Attach. 4).

In any event, in response to the Commission's new rules, Ameritech Illinois has hired additional employees in its business and repair offices. This will assure staffing sufficient to comply with the 60-second answer time requirement in the Commission's Part 730 rules. (Am. Ill. Ex. 12.0, p. 10; Am. Ill. Ex. 12.1, p. 3). Once again, subsequent performance reflects Ameritech Illinois' additional hiring (and spending). As of the first of the year, business and repair office answering times averaged 60 and 31 seconds, respectively, for all calling centers. (Am. Ill. Ex. 12.1, p. 3).

Finally, two of the GCI parties -- CUB and the Attorney General -- contend that Ameritech Illinois "currently" queues customers from other states ahead of Illinois customers on calls to collection centers. (CUB Init. Br., p. 39; AG Init. Br., p. 43). Those claims are wrong, as Mr. Hudzik specifically explained both in his pre-filed testimony and during cross-examination. In fact, the queuing process described by the GCI was limited to a single call center for a short period of time prior to the effective date of the Commission's answer time standards. No such queuing of customers has occurred since October 2000. (Am. Ill. Ex. 12.0, p. 20; Tr. 1941-42, 1944-45, 2029).

5. <u>Prejudice or Disadvantage To Customers</u>

CUB and the Attorney General claim that the Plan has prejudiced and disadvantaged customer classes. (CUB Init. Br., p. 46; AG Init. Br., pp. 46-47). CUB makes the remarkable claim that the Plan "unduly disadvantaged noncompetitive service customers as a whole". However, the concept of prejudice involves the favoring of one customer class at the expense of another: under Section 13-506.1(b)(7), the Plan may not unduly prejudice "any particular customer class" (emphasis added). It makes absolutely no sense from a logical or statutory perspective to claim prejudice to every noncompetitive service customer.

Beyond that, CUB and the Attorney General primarily recast their complaints about lack of competition, service quality, earnings, and the treatment of calling plans under the basket structure as "prejudice" issues. Again, to the extent these complaints have any merit -- and the Company believes that they do not -- they impact all noncompetitive customers equally and, therefore, have nothing to do with prejudice or disadvantage within the meaning of Section 13-506.1(b)(7).

Finally, the Attorney General complains that Ameritech Illinois' rate design decisions under the Plan have primarily benefited customers who make use of the Company's network. (AG Init. Br., p. 47). The Attorney General would have preferred reductions in network access lines, which are subscribed to by customers who make little or no use of the network. This does not constitute "prejudice" or "disadvantage". The Company made clear in 1994 that residential network access lines were underpriced and that it had no intention of reducing those rates under the Plan. 1994 Order at pp. 63, 68. As evidenced by the Company's rate rebalancing proposal, circumstances have not changed. The Company's consistent pricing policy over the last seven years relative to this issue has not been "prejudicial" within the meaning of the statute. Moreover, the Company is at a loss to understand why it is unreasonable for rate reductions to flow more heavily in the direction of customers who actually make use of its network, as compared to customers who do not. This result increases overall consumer welfare, as discussed infra.

6. Regulatory Delay and Costs

Staff agrees that the Plan has clearly reduced regulatory delay and costs. (Staff Init. Br., p. 17). CUB complains that the cumulative amount of time required by the annual filings has exceeded that of a general rate case, a contention which is patently untrue. (Am. Ill. Init. Br., p. 31).[9] CUB further claims that the SBC/Ameritech merger and competitive classification proceedings would not have occurred under rate of return regulation. However, SBC made clear in the merger proceeding that the driving force behind the merger was the need to achieve the scale and scope of a global telecommunications company; only financially punitive regulatory climates in all five Ameritech states (not just continued rate of return regulation in Illinois) would likely have changed SBC's decision. (Am. Ill. Ex. 1.3, pp. 44-45). The ongoing debates over competitive classifications have nothing to do with the Plan. As the Company stated, these reclassifications would have been made regardless of what form of regulation applied; the increased incidence over the first term of the Plan reflects the fact that competition significantly increased during this period. (Am. Ill. Ex. 1.3, pp. 29-30, 45; Am. Ill. Ex. 1.4, pp. 41-43).

7. Innovation

CUB claims that Ameritech Illinois did not engage in sufficient innovation during the first term of the Plan. (CUB Init. Br., pp. 22-23). CUB complains that most "innovations" can

[9] CUB harps on the fact that the original proceeding took 22 months to complete. The 1994 proceeding should not be counted against the Plan; the Commission appropriately examined the issues carefully. (Am. Ill. Ex. 1.3, pp. 42-43). Furthermore, there was substantial "down time" during that proceeding: over five months passed between the close of the record and the issuance of the HEPO, and another five months passed between the issuance of the HEPO and the Commission's Order. 1994 Order at pp. 2, 198. During those periods, the usual briefing/exceptions/oral argument processes occurred, but nothing more.

be traced to equipment vendors, not Ameritech Illinois This is not the Company's failing: vendors develop the switch hardware and software that enables new features and functionalities for the entire industry, a point which Ameritech Illinois made first in its own testimony. (Am. Ill. Ex. 1.1, p. 51). Short of becoming an equipment manufacturer -- hardly a realistic alternative -- Ameritech Illinois' service introduction record is solid. (Am. Ill. Ex. 1.1, pp. 50-52).

8. Broad Dissemination of Technical Improvements and Economic Development

CUB and the Attorney General dispute that the Plan has facilitated the broad dissemination of technical improvements to all classes of ratepayers. (CUB Init. Br., pp. 25-27; AG Init. Br., p. 48). CUB relies on Dr. Selwyn's "net investment" argument. By subtracting depreciation accruals associated with existing plant from the $3.7 billion of new investment over the five-year term, Dr. Selwyn claimed that Ameritech Illinois only invested a "net" of $300 million in its network and, therefore, is not infusing new capital into its business. This argument has no basis in any legitimate financial or economic theory. Like any capital intensive company, Ameritech Illinois incurs substantial depreciation expense which reflects both wear and tear as well as technological obsolescence. The relevant measure of Ameritech Illinois' investment in its network is the $3.7 billion, not the net figure cited by CUB. The Commission ignored Dr. Selwyn when he made a similar argument in the 1994 proceeding and it has not improved with age. (Am. Ill. Ex. 1.4, pp. 49-51).

CUB and the Attorney General claim that Ameritech Illinois should have demonstrated that its network investment promoted economic development with more specificity. (CUB Init. Br., pp. 26-27; AG. Init. Br., p. 48). However, the relationship between network investment and economic development can only be established at a broad, macroeconomic level. (Am. Ill. Ex. 1.3, pp. 41-42). Even Dr. Selwyn testified that he was not expecting the Company to establish a linkage between specific network investments and economic development. (Chicago Ex. 2.0, p. 34). CUB further suggests that Ameritech Illinois was obligated to duplicate the economic analysis provided in the 1994 proceeding in <u>this</u> proceeding. Nothing in the Commission's 1994 Order supports this claim.

The Attorney General and Cook County argue that Ameritech Illinois has failed to invest in aspects of the network which benefit POTS service. They claim, for example, that Project Pronto does little to benefit POTS customers. (AG Init. Br., pp. 14-16; Cook County Init. Br., pp. 56-57). These arguments fundamentally misrepresent Project Pronto. Project Pronto is not a "DSL project". It is an overall network modernization program which benefits <u>all</u> customers. (Am. Ill. Ex. 5.0). In fact, because the DSL aspects of Project Pronto are currently being deferred, Project Pronto now benefits <u>only</u> POTS services. (Tr. 1989-92).

9. <u>Competition</u>

GCI continues to complain that residential competition has not developed sufficiently. (City Init. Br., pp. 14-16; CUB Init. Br., pp. 13, 35; AG Init. Br., pp. 31-32). This is not attributable to the <u>Plan</u>. GCI ignores the numerous, complex factors which have contributed to the slow growth in residence lines served by competitors: low profit margins in the local exchange business relative to other CLEC business opportunities; strategic decisions by the IXCs; and unrealistic regulatory expectations. (Am. Ill. Ex. 1.1, pp. 46-48; Am. Ill. Ex. 1.3, pp. 69-70). Moreover, despite these factors, CLECs have recently demonstrated a renewed interest in serving residence customers in Illinois. (Am. Ill. Ex. 1.3, p. 72; Am. Ill. Ex. 1.4, Sch. 2, 3). GCI's continual handwringing over the level of competition simply cannot be squared with its proposed $1 billion rate reduction, hundreds of millions of which result from imputed revenues and/or disallowances which bear no relationship to financial reality. If these adjustments were to be adopted, they would disincent all competition, including efficient competition. (Am. Ill. Ex. 1.4, pp. 62-64). GCI wants it "all" -- uneconomically low consumer rates and competition. That is not how the marketplace works and wishing will not make it so.[10]

III. ONLY MODEST ADJUSTMENTS TO THE PLAN ARE REQUIRED ON A GOING FORWARD BASIS

Staff fully supports continuation of the Plan, subject to certain terms and conditions which Staff views as essential. (Staff Init. Br., pp. 3-4). These terms and conditions are as follows:

(i) A one-time reduction in Ameritech Illinois' rates of $36.9 million, to reflect Staff's interpretation of the "Installation Within 5 Days" service standard and the recent reclassification of certain residence services as noncompetitive;

(ii) Retention of the existing price index, with a chain-weighted GDPPI, a 4.3% X factor, and a reinitialized API/PCI;

(iii) Clarification of the exogenous change factor to include Commission-mandated rate reductions;

(iv) A modified service quality plan, which provides credits directly to customers, as well as the provision of wireless phones in certain circumstances;

(v) Retention of the four baskets in the Plan structure, retention of the existing 2% limit on pricing flexibility, and reassignment of residential calling plans to the "Residence" basket;

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10 The record demonstrates that competition is increasing significantly at the Company's existing rate levels. CLEC monthly "run rates" (i.e., net local access lines added per month by CLECs), have increased from approximately 5,000 in December of 1998 to over 16,000 in October of 2000; by October 2000, Ameritech Illinois was losing 16,000 lines per month. Moreover, this data understates competitive activity because it ignores self-provisioning by CLECs over their own facilities and substitute services. (Am. Ill. Ex. 4.2, pp. 25-26).

Moreover, if these services were competitive, there would be no need for the Plan at all. (Am. Ill. Ex. 4.3, p. 29).

(vi) Rejection of Ameritech Illinois' rate rebalancing proposal; and

(vii) Rejection of CUB/AG's earnings complaint.[11]

Ameritech Illinois' and Staff's positions are not that far apart on many of these issues. The Company agrees that the existing price index should be retained and that the chain-weighted version of GDPPI should be substituted for the existing version; the Company believes, however, that the X factor should be 3.3% instead of 4.3% (eliminating the 1% consumer dividend) and that the API/PCI should not be reset to 100 (Issue (ii)). The Company and Staff are in agreement on clarification of the exogenous change factor (Issue (iii)). Ameritech Illinois is willing to adopt Staff's approach to service quality, as long as the penalty amounts are reasonable (Issue (iv)). The Company and Staff are in agreement that CUB's earnings complaint should be dismissed or denied (Issue (viii)). However, the Company believes that Staff's positions generally on pricing are insufficiently forward-looking and they should not be adopted (Issues (v) and (vi)). There is also no basis for Staff's proposed $36.9 million rate reduction (Issue (i)). These issues will be discussed at greater length infra.

A. Existing Components of the Plan

1. The Price Index

a. The Measure of Inflation

The parties continue to be in agreement that the chain-weighted version of GDPPI should be substituted for the fixed-weight version. Staff further indicates in its Initial Brief that use of the chain-weighted version will alleviate certain objections which it had to the restating of

[11] It is Ameritech Illinois' understanding that these seven items represent Staff's core concerns in this proceeding, and that any statements in text surrounding these items are to be construed in that context.

GDPPI in past annual filing proceedings. (Staff Init. Br., pp. 15-16). If so, then use of the chain-weighted version will provide additional benefits. However, it is the Company's understanding that the Bureau of Economic Analysis (BEA) provides preliminary and revised series of the chain-weighted GDPPI, just as it did for the fixed-weight version.[12]

b. The Productivity Offset

Contrary to Ameritech Illinois' and Staff's recommendations, GCI contends that the X factor should be set at 6.5%, to mirror the FCC's CALLS proposal. (CUB Init. Br., pp. 52-54; AG Init. Br., pp. 51-53; City Init. Br., p. 41; Cook County Init. Br., pp. 33-35).[13] Ameritech Illinois outlined the reasons why the FCC's X factor cannot be used in this proceeding in its Initial Brief. (Am. Ill. Init. Br., pp. 38-40). Contrary to the Attorney General's contention, the FCC's 6.5% offset is not a productivity factor and it was not "agreed to" by SBC and other ILECs as a productivity factor. The CALLS proposal represented a comprehensive settlement of many outstanding issues at the federal level. The Attorney General attempts to side-step these facts by claiming that the "label" attached to the 6.5% offset is irrelevant. However, the FCC's Orders make clear that it is a "ramp-down method" of achieving certain FCC pricing objectives and it will disappear when the FCC's target is achieved, hardly the mark of a conventional X factor. (Am. Ill. Ex. 2.2, pp. 18-19; Am. Ill. Ex. 2.3, pp. 9-10). This Commission is not free to adopt ratemaking tools from other jurisdictions without substantial evidence in this record

12 The Attorney General suggests that the date of the annual price cap filing be moved to September 30 to accommodate revisions to GDPPI. (AG Init. Br., p. 9). This proposal appears in the Attorney General's Initial Brief for the first time. It is unclear to the Company what benefits, if any, would be achieved in the annual filing process.

13 CUB's Initial Brief is confusing, in that it suggests that Ameritech Illinois is recommending use of a Company-specific X factor. (CUB Init. Br., pp. 50-51). This is simply untrue. From the outset of this proceeding, the Company has recommended use of an industry-wide TFP factor. An Ameritech Illinois-specific TFP study was presented because it was required by the Commission's 1994 Order. (Am. Ill. Ex. 2.3, pp. 3-4).

supporting their use. Union Elec. Co. v. Ill. Comm. Comm., 77 Ill. 2d 364, 383 (1979). No such record exists here.

CUB contends that Dr. Meitzen's analysis is flawed because it used an economy-wide cost of capital, rather than a LEC-specific cost of capital. (CUB Init. Br., p. 52). CUB is ignoring the alternative TFP runs which Dr. Meitzen performed at Dr. Staranczak's request, which used a wide range of capital costs (including Staff's recommendation in this proceeding). (Am. Ill. Ex. 2.2, pp. 7-8). There was no appreciable impact on Dr. Meitzen's results; in fact, use of Staff's recommended cost of capital actually caused the TFP results to decline. CUB's failure to even acknowledge this undisputed record evidence is sloppy advocacy.[14]

The Attorney General relies on Dr. Selwyn's so-called "implied X factor analysis" to claim that a high X factor should be used. (AG Init. Br., pp. 51-52). This is not an analysis of TFP. It is simply a reverse engineering of Ameritech Illinois' 1999 total company earnings. Not even Dr. Selwyn claimed that it could or should be used to establish an X factor. (GCI Ex. 3.0, p. 26). This argument is nothing more than GCI's earnings claims in a different guise. (Am. Ill. Ex. 1.3, pp. 78-79).

Finally, CUB contends that use of the FCC's factor is required to prevent "windfall gains". (CUB Init. Br., p. 53). This is incorrect. There is no evidence in the record of this proceeding that either Ameritech Illinois' own historical TFP performance or that of the LEC industry as a whole even remotely approaches 6.5%. As a result, use of the FCC factor would

[14] CUB contends that the FCC's X factor is superior because the predecessor TFP analysis performed by the FCC attempted to use "physical output measures", rather than the deflated revenues approach. (CUB Init. Br., pp. 51-52). However, as both Dr. Meitzen and Dr. Staranczak agree, the deflated revenues approach is a well-accepted methodology and the FCC did not incorporate enough output measures to produce reliable results. (Am. Ill. Ex. 2.2, pp. 9-11, 15-16; Staff Ex. 16.0, pp. 10-14).

require Ameritech Illinois to flow through to noncompetitive services productivity gains that are entirely fictional.

b. The Exogenous Change Factor

Staff supports clarification of the exogenous change factor to allow the Company to offset Commission-mandated rate reductions on an expedited basis. (Staff Init. Br., pp. 36-37). As Staff states: "It is desirable from a public policy standpoint to institute a systematic and predictable mechanism for revenue recovery under these circumstances." (Id.)

GCI opposes this change. (CUB Init. Br., pp. 57-59; AG Init. Br., pp. 62-63; City Init. Br., p. 41). CUB claims that the Company's proposal would "circumvent the Commission's discretion to determine whether the price regulation formula is just and reasonable absent the offset". (CUB Init. Br., p. 57). However, the Commission will be determining in this proceeding a "just and reasonable" price index. Unless and until the Commission develops a new X factor in a subsequent proceeding based on substantial evidence, Ameritech Illinois' obligation is to adjust its rates by the amount required by that index -- not the index plus whatever other service-specific rate reductions the Commission may want to order. As Dr. Staranczak explained, denial of exogenous change treatment in those circumstances would unilaterally increase the X factor and such a result would be improper. (Tr. 1276-77).[15] It is no answer to claim -- as CUB does -- that the Company could use the ratemaking provisions of Article IX of the PUA or ask to rescind the Plan. The Company is entitled to offset these rate

[15] CUB's argument that demand effects would be "difficult to isolate" is a red herring. Staff has proposed that the revenue effect of all rate changes proposed in this proceeding be determined on a demand-adjusted basis -- there is nothing unique about carrier access services. Furthermore, the Commission's Order in Dockets 97-0601/0602 required the IXCs to flow these rate reductions through to their own retail rates on a revenue-neutral basis. Phase II Order in Dockets 97-0601/0602, adopted March 29, 2000, at pp. 53-54. Presumably, the IXCs have already included the demand effects of reduced toll rates in developing their revised rate schedules. These data could be used to supplement Ameritech Illinois' analyses.

decreases as a matter of policy, economic principles and equity. It should not have to run the gauntlet of a proceeding like this one just to remain whole under the index.

Finally, CUB argues that Ameritech Illinois' proposal is circular, claiming that rate reinitialization in this proceeding would result in a request from the Company for exogenous treatment. (CUB Init. Br., p. 58). This is nonsense. Although Ameritech Illinois has opposed rate reinitialization from the outset of this proceeding, it has never suggested that it would claim exogenous treatment if the Commission rejected its views. The Company's exogenous change proposal is limited to the access charge proceeding (Docket 97-0601/0602) and any Commission-mandated rate reductions which occur after this review proceeding has been completed.

2. Pricing Flexibility

Staff and GCI continue to oppose Ameritech Illinois' pricing flexibility proposal. Both Staff and CUB complain that Ameritech Illinois has not explained why it needs flexibility to price services "for which it has no competitors". (Staff Init. Br., pp. 41-42; CUB Init. Br., pp. 60-61). They are both deliberately missing the point. As Dr. Harris explained, well-designed price regulation plans allow the regulated company to make gradual changes in its rate structure in preparation for competition and simply to improve allocative efficiency. (Am. Ill. Ex. 1.2, pp. 21-22; Am. Ill. Ex. 4.0, pp. 51-52; Am. Ill. Ex. 4.1, pp. 3-4). Increases in network access lines are needed to accomplish both objectives.

Furthermore, it is ridiculous for either CUB or Staff to suggest that the mere fact that a service is classified as noncompetitive today means that there are "no" competitors in the marketplace and that there will be none over the next term of Plan. Competitors are active today. (Am. Ill. Ex. 1.4, p. 79; Schs. 2, 3). Furthermore, given their views of Section 13-502(b), it is more than a little disingenuous to pretend that a noncompetitive classification means that there are (or will be), in fact, no competitors. (Staff Ex. 3.0, pp. 4-7; City Ex. 1.0, pp. 22-26; Tr. 603-04). The development of competition is a continuum, not a binary event.

CUB claims that Ameritech Illinois' network access line rates are "further above cost" today than they were in 1994, because they remained constant, while other rates declined. (CUB Init. Br., p. 61). This is incorrect. The LRSIC costs associated with providing network access lines have increased, not decreased. Furthermore, even if one were to view this issue from an X factor perspective as CUB does -- which is economically invalid -- there is not one shred of evidence in this record that the efficiency gains which the Company achieved related to its provision of network access lines.

Staff's and GCI's shrill arguments that any increase in network access line prices constitutes "an attempt to inflict so-called 'Ramsey pricing' practices upon captive customers" are shortsighted from a policy perspective and wrong from an economic perspective. (Staff Init. Br., p. 42; AG Init. Br., pp. 55-56; CUB Init. Br., p. 62; Cook County Init. Br., p. 37). The Company recognizes that Staff and GCI have concerns about the validity of its cost studies. However, none of the parties have seriously attempted to assess where network access line prices need to be over the long run to facilitate economic efficiency and competition. Whether or not network access line prices cover their LRSIC costs -- and the Company believes that they do not -- substantially higher levels of contribution should be expected from this service. As the record makes clear, all services must be priced significantly above LRSIC for the Company to be financially viable. (Am. Ill. Ex. 1.2, pp. 8-14; Am. Ill. Ex. 1.4, pp. 80-81). Even on an accounting basis, the state-wide average rate of $11.81 for residence network access lines is substantially below their "cost" of $19.12. (Am. Ill. Ex. 1.3, p. 147). This situation cannot continue indefinitely.

Since network access line rates have not changed since 1990, this proceeding provided the ideal opportunity to make progress towards a better rate structure. However, residence access line price increases have apparently become the "third rail" in regulatory proceedings in this state, notwithstanding this Commission's history of taking politically difficult actions to advance economically sound pricing structures. (Am. Ill. Ex. 1.1, pp. 19-20; Am. Ill. Ex. 1.2, p. 4). As a result, the parties (including Staff) have generally preferred to play "pin the tail on the cost studies" and have refused to engage in any serious discussion of network access line repricing simply by attaching the dreaded "Ramsey pricing" label to it. If the Commission does not adopt the Company's rate rebalancing proposal, it is all the more critical to provide some reasonable amount of flexibility to address the problem.

The Company recognizes that reasonable people can differ over what degree of flexibility it should have under the Plan. However, Staff's and GCI's insistence that the Plan change not at all -- that is, that the Company have no ability to increase prices by even a penny (assuming continuation of current economic conditions) -- is not reasonable and will not serve the long run interests of customers in this state.

CUB and the Attorney General contend that another rate cap on basic residential services is required as a matter of law under Section 13-506.1(c). (CUB Init. Br., pp. 11, 63-64; AG Init. Br., p. 58). They argue that whatever emerges from this proceeding constitutes a "new" plan, which triggers the 180-day rule in Section 13-506.1(c): i.e., that for the next three years, basic residential rates cannot be higher than the rates in effect over the last 180 days.[16]

[16] In a remarkable show of independence, Cook County expresses uncertainty as to whether it would be a new or modified plan. (Cook County Init. Br., p. 43).